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No. 98-2043

Supreme Court, U.S.  
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IN THE  
**Supreme Court of the United States**

HUNT-WESSON, INC.,

v.

*Petitioner,*

FRANCHISE TAX BOARD,

*Respondent.*

On Writ of Certiorari to the  
Court of Appeal of California  
for the First Appellate District

BRIEF OF GENERAL ELECTRIC COMPANY  
AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONER

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## QUESTIONS PRESENTED

1. Whether a State may tax constitutionally exempt income under the guise of denying a deduction for expenses in an amount equal to such income when there is no evidence that the expenses relate to the production of the exempt income.

2. Whether a state tax discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense, thereby increasing California taxable income, solely because the corporation is not domiciled in the State or does not have subsidiaries that engage in taxable in-state activity.

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BRIEF OF GENERAL ELECTRIC COMPANY  
AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONER

INTEREST OF *AMICUS CURIAE*<sup>1</sup>

The General Electric Company ("GE") is a multistate and multinational company headquartered in Fairfield, Connecticut. GE operates in more than 100 countries around the world and employs over 290,000 people. Over half of those employees are in the United States, and over 10,000 in the state of California alone. GE has numerous business segments that provide a broad range of goods

<sup>1</sup> Pursuant to Rule 37.6 of the Rules of this Court, *amicus* states that no counsel for a party authored this brief in whole or in part, and that no person or entity other than *amicus*, its members, or its counsel, has made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.3, *amicus* states that petitioner and respondent have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of this Court.

and services throughout the United States and the world, including aircraft engines, appliances, capital services, industrial systems, lighting, medical systems, the NBC television network, plastics, power systems and transportation systems. In 1998, GE revenues exceeded \$100 billion, with net earnings of over \$9 billion. As a result, GE bears substantial tax burdens, both in the United States and abroad.

GE believes it is evident that California's dollar-for-dollar interest offset rule has a significant, deleterious effect on interstate commerce, which will only be exacerbated if other states follow California's lead and adopt similar offset provisions. GE believes that all of the states will best be served by tax rules that properly recognize the interstate character of many companies' businesses through a proper allocation of expense to taxable and nontaxable classes of income. Because of its years of practical experience with state taxation, GE believes that it is uniquely suited to assist the Court in evaluating the dollar-for-dollar interest offset rule California improperly has adopted, and to that end offers its insights into the legal issues raised by this case.

### SUMMARY OF ARGUMENT

California is proscribed under the Due Process and Commerce clauses from taxing income of a nondomiciliary corporation that is not connected to the trade or business it carries on in California. Consequently, as a general matter, California is precluded from taxing dividends that a nondomiciliary corporation receives from a subsidiary, if the subsidiary and the nondomiciliary parent are not engaged in an integrated trade or business. The statute at issue in this case, Cal. Rev. & Tax. Code § 24344(b), however, applies an "interest offset" rule that arbitrarily requires a nondomiciliary corporation to reduce its deduction for net interest expense (*i.e.*, business interest expense

in excess of business interest income), dollar-for-dollar, by the amount of income it receives that California may not constitutionally tax.

This Court has never permitted constitutionally tax exempt income to be used to offset other expenses, unless the government demonstrates that the expenses are attributable to the nontaxable income either by means of a direct tracing or by proration or apportionment of expense between taxable and nontaxable income. *E.g.*, *National Life Ins. Co. v. United States*, 277 U.S. 508, 520-22 (1928); *United States v. Atlas Life Ins. Co.*, 381 U.S. 233, 249-51 (1965).

California's interest offset rule is fundamentally flawed under this approach because it uses constitutionally nontaxable income to offset unrelated expenses, dollar-for-dollar, instead of making any attempt to match the interest expense to the taxable and constitutionally nontaxable income to which it is related. As a result, the interest offset rule is unconstitutional for two reasons. *First*, it permits California to tax indirectly that which it cannot tax directly. *Second*, by disallowing a deduction solely because the taxpayer is a nondomiciliary corporation, the interest offset rule facially discriminates against interstate commerce and *per se* violates the Commerce Clause.

### ARGUMENT

#### I. BACKGROUND.

##### A. Constitutional Limitations On State Taxation.

California imposes a franchise tax, measured by net income, on all corporations doing business in the state. Cal. Rev. & Tax. Code §§ 23151, *et seq.* Like all states, California is prohibited by the Commerce and Due Process clauses of the United States Constitution from taxing



income of a nondomiciliary corporation if that income is earned outside California and bears no connection to a trade or business the corporation conducts in California. U.S. Const. art. I, § 8, cl. 3, and amend. XIV, § 1; *Allied-Signal, Inc. v. Director, Div. of Taxation*, 504 U.S. 768, 777 (1992). This type of income is commonly referred to as "nonbusiness" income.<sup>2</sup> The parties to this case have stipulated that the dividends that are at the center of this controversy were nonunitary, nonbusiness dividends not subject to taxation by the State of California. Joint Stipulation of Facts ¶ 8, Clerk's Transcript p. 58. The dividends were not subject to California tax because California was constitutionally prohibited from taxing such dividends.

In order for a state to tax a nondomiciliary corporation's income derived from out-of-state activities, there must be both a nexus between such activities and the taxing state and a rational relationship between the income attributed to the taxing state and the extent of business conducted in the state. *E.g.*, *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 165-66 (1983). In other words, a state may tax income from a taxpayer's out-of-state activities only if those activities are part of the integrated activities of a "unitary business."<sup>3</sup>

<sup>2</sup> The term "nonbusiness" income is a statutory term that generally includes income that a state cannot tax because it does not bear the operational connection to the business conducted in the taxing state that is required by *Allied-Signal*. For ease of reference, we will refer to such income generically, and interchangeably, as "nonbusiness," "nontaxable" or "exempt" income.

<sup>3</sup> A unitary business exists when the intrastate and out-of-state activities of a company are integral parts of a single enterprise. A unitary business may include vertically integrated entities of one enterprise or several similar entities operating in various jurisdictions but conducting a common enterprise. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 166 (1983). The hallmarks of a unitary

A state may tax income a nondomiciliary corporation receives from intangible assets, such as dividend income, only if the payor of the income is engaged in a unitary business with the payee or if the income-generating asset serves an operational, rather than an investment, function of the payee. *Allied-Signal*, 504 U.S. at 777. For example, in *Mobil Oil Corp. v. Commissioner of Taxes*, the Court held that Vermont was permitted to tax dividends that Mobil, a nondomiciliary, received from foreign subsidiaries because the subsidiaries' petroleum production operations were part of a unitary business with Mobil's petroleum retailing operations in Vermont. 445 U.S. 425, 439 (1980). In contrast, the Court held that a state could not tax the dividends a nondomiciliary corporation received from nonunitary subsidiaries in *ASARCO Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 327-28 (1982), and *F.W. Woolworth Co. v. Taxation & Revenue Department*, 458 U.S. 354, 364 (1982). Most recently, the Court in *Allied-Signal* held that New Jersey could not tax the gain that Allied-Signal's predecessor in interest, Bendix Corp., a nondomiciliary, realized on the sale of its 20.6% stock interest in ASARCO. 504 U.S. at 787. Bendix and ASARCO were not engaged in a unitary business and Bendix's interest in ASARCO served an investment rather than an operational function, even though the ASARCO stock had been purchased as part of a long-term strategy of corporate acquisitions and dispositions. *Id.*

These principles establish that California could not, consistent with the Constitution, directly tax the dividends at issue, which the parties stipulated were nonunitary, nonbusiness dividends.

business are operations linked by functional integration, centralization of management, and economies of scale. *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980); *F.W. Woolworth Co. v. Taxation of Revenue Dep't*, 458 U.S. 354, 364 (1982).

### B. California's Taxation Of Business And Nonbusiness Income.

In order to implement the constitutional limitations on state taxation, states use a number of specific allocation rules for attributing nonbusiness income to the state in which it is earned. Generally, income derived from tangible property (whether personal or real) is allocated to the state in which the property is located. California has adopted such a rule. Cal. Rev. & Tax. Code § 25124. In contrast, income from intangible property, such as interest and dividend income (the type of income involved in this case), generally is allocated entirely to the commercial domicile of the recipient of the dividends. That rule, too, has been adopted by California. *Id.* § 25126.

Most, if not all, states that impose an income tax, including California, require a corporation to apportion by formula income earned from a trade or business ("business income") conducted both within and without the taxing state. Although there are some variations among the states, the apportionment formulae generally take into account the proportions of the corporation's property, payroll and sales in the taxing state in determining the share of the corporation's business income that the state may subject to tax.<sup>4</sup> In determining the amount of net taxable business income that may be apportioned, most states, again including California, permit a deduction from gross income for interest expense paid or incurred. *Id.* § 24344(a).

California, however, intentionally overreaches by arbitrarily limiting a corporation's interest deduction in a

<sup>4</sup> California used the "three-factor" property, payroll and sales formula during the tax years in issue, but began using a variation on that formula that gives double weight to sales, effective October 8, 1993. Cal. Rev. & Tax. Code § 25128.

manner that violates both the Due Process and Commerce clauses. The specific limitation in question is the so-called "interest offset" rule. *Id.* § 24344(b).<sup>5</sup> That rule arbitrarily requires a corporation to reduce all of its net interest expense (*i.e.*, the excess of its business interest expense over its business interest income), dollar-for-dollar, by the amount of its nonbusiness dividend and interest income, which *cannot* properly be taxed by California. The interest offset overreaches by failing to match that interest expense to the business and nonbusiness income to which it is related—whether by a direct tracing or by a reasonable apportionment. Instead, it simply assigns the first dollars of net interest expense to income that California may not tax, and allows only the balance, if any, to be used as a deduction from the income that California taxes. See *Pacific Tel. & Tel. Co. v. Franchise Tax Bd.*, 498 P.2d 1030, 1035 (Cal. 1972).

The abject failure of section 24344(b) to match interest expense to the related taxable and nontaxable income has two unconstitutional effects. *First*, in violation of the Due Process and Commerce clauses, it permits California effectively to tax nonbusiness income, which is, by definition, income that California is constitutionally prohibited from taxing. *Second*, in violation of the Commerce

<sup>5</sup> During the tax years in issue, Section 24344(b) (1979) provided:

If income of the taxpayer is determined by the allocation formula contained in Section 25101, the interest deductible shall be an amount equal to interest income subject to allocation by formula, plus the amount, if any, by which the balance of interest expense exceeds interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula. Interest expense not included in the preceding sentence shall be directly offset against interest and dividend income (except dividends deductible under the provisions of Section 24402) not subject to allocation by formula.



Clause, it results in facial discrimination against interstate commerce by disallowing a deduction based solely upon the commercial domicile of the taxpayer. Put differently, the interest offset rule favors corporations with a commercial domicile in California while at the same time disadvantaging corporations whose commercial domiciles are elsewhere.

## II. THE INTEREST OFFSET RULE IMPROPERLY PERMITS CALIFORNIA TO TAX INDIRECTLY THAT WHICH IT CANNOT TAX DIRECTLY.

It is well settled that a state may not tax indirectly that which it cannot constitutionally tax directly. *E.g.*, *The Passenger Cases*, 48 U.S. (7 How.) 283, 458 (1849) (Grier, J., opinion); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643, 645-46 (1925). The effect of section 24344(b) is to permit California to tax indirectly the nonbusiness dividends that it is constitutionally precluded from taxing directly. Specifically, by reducing the interest expense deduction, dollar-for-dollar, by the amount of nontaxable, nonbusiness income, California increases the tax base of a nondomiciliary corporation by the exact amount of its constitutionally nontaxable, nonbusiness income.

### A. California Does Not Fairly Attribute Interest Expense To Nontaxable Income.

It is undisputed that California may burden nontaxable income with the expenses attributable to generating that income. The fundamental flaw of section 24344(b) is that it provides no mechanism for matching interest expense to the taxable or nontaxable income to which it is related. Instead, it arbitrarily assigns net interest expense first to constitutionally nontaxable income and allows only

the balance, if any, to be used as a deduction against taxable income.

### 1. The State May Disallow Only That Interest Which Is Fairly Related To The Nontaxable Income.

This Court has never permitted constitutionally tax exempt income to be used to offset other expenses, unless the government demonstrates that the expenses are attributable to the nontaxable income either by means of a direct tracing or by proration or apportionment of expense between the taxable and nontaxable income. The Court addressed this issue over 70 years ago in *National Life Insurance Co. v. United States*, 277 U.S. 508, 521 (1928), and as discussed below, has not wavered from the principles set forth in that case.

In *National Life*, section 245(a) of the Revenue Act of 1921 reduced an insurance company's federal income tax deduction for additions to its reserve, dollar-for-dollar, by the amount of its tax exempt income (*i.e.*, income from state and municipal obligations that was constitutionally exempt from federal taxation). The taxpayer thus paid the same amount of tax whether its income was comprised of taxable or tax exempt income, prompting the Court to observe: "One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free." *Id.* at 519.

In *Denman v. Slayton*, 282 U.S. 514, 518 (1931), the Court upheld section 214(a)(2) of the Revenue Act of 1921, which denied a federal income tax deduction for interest paid or accrued "on indebtedness incurred or continued to purchase or carry" tax exempt securities. The taxpayer paid the interest on "money borrowed . . . for the purpose of purchasing and carrying exempt securities." *Id.* at 517 (emphasis added). In that case there

was a directly traceable relationship between the interest disallowed and the exempt securities. The Court explained that:

[w]hile guaranteed exemptions must be strictly observed, this obligation is not inconsistent with *reasonable* classification designed to subject all to the payment of their *just* share of a burden *fairly* imposed.

*Id.* at 519 (emphases added).

In *United States v. Atlas Life Insurance Co.*, 381 U.S. 233, 249-51 (1965), the Court upheld a *pro rata* apportionment of exempt securities between taxable and nontaxable income. Under the Life Insurance Company Income Tax Act of 1959, a life insurance company's investment income was divided between the policyholders' share (*i.e.*, the reserve for payment of future claims) and the company's share (its own taxable investment income). Pooled investments, including tax exempt interest income, were allocated *pro rata* between the policyholders' and the company's share of income. In computing its taxable investment income, the company was entitled to deduct the *pro rata* portion of tax exempt income included in the company's share of investment income. The taxpayer, however, argued that it should have been able to allocate all of the tax exempt investment income to the company's share, because the company did not pay any tax on the policyholders' share in any event. The Court rejected this argument, stating:

[T]he formula treats taxable and exempt income in the same way, deeming that both are saddled with an equal share of the company's obligation to policyholders. We think that Congress can treat the receipts from investment of a pool of fungible assets in this manner and that the taxpayer's desired allocation of these receipts is not constitutionally required.

*Id.* at 250. The Court specifically distinguished this constitutional allocation from the dollar-for-dollar offset found unconstitutional in *National Life*. *Id.* at 243-44.

More recently, in *First National Bank v. Bartow County Board of Tax Assessors*, 470 U.S. 583, 588-97 (1985), the Court addressed a Georgia property tax imposed on the fair market value of a bank's stock. The Court earlier had ruled in *American Bank & Trust Co. v. Dallas County*, 463 U.S. 855, 865 (1983), that Rev. Stat. § 3701, as amended, 31 U.S.C. § 742, prohibited a state from imposing a property tax on bank shares without allowing a deduction for federal obligations. The Georgia Supreme Court construed its state's taxing statute to allow a deduction from net worth in the same proportion as the bank's federal obligations to the bank's total assets. In other words, if the bank's federal obligations constituted 9.75% of its total assets, then the bank was entitled to a deduction of an amount equal to 9.75% of its net worth. In upholding this scheme, the Court stated:

We see no need to depart from the principle established in *Atlas Life* that a *pro rata* deduction that does no more than allocate to tax-exempt values their "just share of a burden fairly imposed" is constitutional. 381 U.S., at 251.

*First Nat'l Bank*, 470 U.S. at 596.

The Court has thus made it abundantly clear that expenses may be attributed to nontaxable income if—and only if—there is a reasonable, but firm relationship between the expenses and the income to which it is to be related. Even where assets and expenses are fungible, this relationship can only be established either by a direct tracing or by a *pro rata* apportionment. The Court clearly has rejected the arbitrary assignment of expenses to constitutionally nontaxable income.



California attempts to defend its arbitrary assignment of interest expense to nontaxable income on the ground that money is fungible and cannot be readily traced. Opp. 12. From that general observation, however, the state jumps to the unwarranted conclusion that the statute reflects "an attempt by the California Legislature to address the complex issue of interest allocation in a rational manner." *Id.* at 13. This argument rings hollow in light of the conclusions reached by this Court in *National Life* and *Atlas Life* that exempt income from fungible investment funds could *not* be subjected to a dollar-for-dollar offset, but rather had to be prorated in some manner to reflect taxable and nontaxable investments.

**2. California Itself Prorates Interest Expense Between Taxable And Nontaxable Income In Other Comparable Contexts.**

The Franchise Tax Board has taken the administrative position that, in the event that Hunt-Wesson prevails in this litigation, the State will begin prorating interest expense between taxable and nontaxable income. California requires a similar proration in other contexts, as well. It is thus no answer to say that the matching of interest expense to the related classes of income is simply too difficult and that California should be spared the bother.

By letter dated December 23, 1997 (the "FTB Letter," attached as Appendix), the Franchise Tax Board informed *amicus curiae* General Electric that in General Electric's docketed administrative case the Board would prorate General Electric's interest expense between nontaxable nonbusiness income and taxable business income in the event Hunt-Wesson prevails in this Court. FTB Letter at 1. Specifically, the Board stated that it would apply the "asset allocation" method to determine a non-

domiciliary's allowable interest expense. The Board set forth the following rationale for its position:

Authority for the asset allocation method is found in R&TC § 25120 and 18 CCR § 25120(d). 18 CCR § 25120(d) provides for the proration of deductions between business and nonbusiness income where expenses related to both classes of income and the proration method fairly distributes the expense. The basis for an asset allocation method to prorate expenses is that money is *fungible* and is attributable to all activities of the taxpayer.

*Id.* (emphasis added).<sup>6</sup>

The Franchise Tax Board further explained that the "asset allocation" method generally follows the rules set forth in Cal. Code Regs. tit. 18, § 24344(c).<sup>7</sup> The asset allocation method propounded by the FTB Letter and by Cal. Code Regs. tit. 18, § 24344(c) generally allocates interest expense directly to assets acquired with the pro-

<sup>6</sup> Cal. Code Regs. tit. 18, § 25120(d) provides:

*Proration of Deductions.* In most cases an allowable deduction of a taxpayer will be applicable only to the business income arising from a particular trade or business or to a particular item of nonbusiness income. In some cases an allowable deduction may be applicable to the business incomes of more than one trade or business and/or to several items of nonbusiness income. In such cases the deduction shall be prorated among such trades or businesses and such items of nonbusiness income in a manner which fairly distributes the deduction among the classes of income to which it is applicable.

GE expresses no view as to whether Cal. Rev. & Tax. Code § 25120(d) and Cal. Code Regs. tit. 18, § 25120(d) do in fact provide the Franchise Tax Board with statutory authority to impose an asset allocation method, or whether that method allocates the proper amount of expenses to nontaxable income.

<sup>7</sup> The purpose of Cal. Code Regs. tit. 18, § 24344(c) is to attribute a *pro rata* portion of interest expense to certain dividends from foreign subsidiaries that are deductible from apportionable business income under Cal. Rev. & Tax. Code § 24411.



ceeds of secured, nonrecourse loans, and prorates the remaining interest expense between taxable and nontaxable income on the basis of the relative values of the taxpayer's taxable and nontaxable assets.

California also has applied a similar apportionment of interest expense between taxable and nontaxable income in other comparable contexts. For example, California permits a deduction under section 24410 for certain dividends received during the year from insurance companies. In that case, California requires the dividend recipient to reduce its deductions only by the amount of its expenses (including interest) attributable to such exempt dividends. For this purpose California prorates a taxpayer's expenses between deductible dividend income and total gross income by multiplying the taxpayer's total expenses by the percentage that its nontaxable dividend income bears to its total gross income. See *In re Appeal of Mission Equities Corp.*, 1975 WL 3263 (Cal. St. Bd. Eq. Jan. 7, 1975); *In re Appeal of Sierra Pac. Indus.*, 94-SBE-002, 1994 WL 14076 (Cal. St. Bd. Eq. Jan. 5, 1994); *In re Appeal of Zenith Nat'l Ins. Corp.*, 98-SBE-001-A, 1998 WL 1109371 (Cal. St. Bd. Eq. Jan. 8, 1998).

In sum, California has established a pattern of prorating expenses between taxable and nontaxable income when the income is nontaxable by statute (as is the case, for example, with respect to sections 24410 and 24411). It is only where the state is prohibited from taxing the dividend income by operation of the Constitution that California uses the full amount of that income to reduce, dollar-for-dollar, the taxpayer's deductible interest expense.

**B. Because The Interest Offset Rule Does Not Fairly Attribute Net Interest Expense To The Related Income, It Improperly Permits California To Tax Indirectly That Which It Cannot Tax Directly.**

The failure of the interest offset rule to match net interest expense to the taxable and nontaxable income to which it is related permits California to tax indirectly the nonbusiness dividends that it is constitutionally precluded from taxing directly. The Court struck down a substantially similar dollar-for-dollar offset in *National Life Insurance Co.*, 277 U.S. at 520-21. As the Court noted, "it becomes apparent that petitioner was accorded no advantage by reason of ownership of tax exempt securities." *Id.* at 519. The Court subsequently summarized its reason for concern in *National Life*:

[T]he result [was] that the company paid as much tax as it would have paid had the same total income been entirely from taxable sources. Under that provision, a company shifting its investments from taxable to nontaxable securities would have lowered neither its taxable income nor its total tax. As compared with the company deriving its income only from taxable sources, the enterprise with the same total amount of investment income derived partly from exempt and partly from taxable sources would pay more tax per dollar of taxable gross income, *i.e.*, taxable income before deduction for the reserve. Unable to perceive any purpose in reducing one deduction by the full amount of another, save for an intent to impose a tax on exempt receipts, the Court ruled that "[o]ne may not be subject to greater burdens upon his taxable property solely because he owns some that is free." 277 U.S., at 519.

*Atlas Life Ins. Co.*, 381 U.S. at 243-44 (third alteration in original).

As a direct result of the interest offset rule, the non-California taxpayer is "accorded no advantage by reason of ownership" of nonbusiness assets outside the state, which are beyond California's ability to tax. Because the statute does not require any relationship between the disallowed interest expense and the nontaxable income, the effect is simply to tax the constitutionally nontaxable income. The following example illustrates this point:

**Example 1.** Parent ("P") is domiciled in Illinois, does business in California, and has a wholly-owned, nonunitary subsidiary ("Sub A"). P has business income of \$200, business interest expense of \$150 and no business interest income. P does not receive any dividend income from Sub A. P's \$150 of interest expense is deducted in full from P's \$200 of business income because there is no nonbusiness dividend or interest income to offset the interest deduction. Thus, P's income subject to apportionment and taxation by California is \$50.

If Sub A were now to pay a \$100 dividend to P, that dividend would constitute nontaxable, nonbusiness income for P since Sub A is a nonunitary subsidiary. California is constitutionally prohibited from taxing P for this out-of-state income. In this case, however, California requires P to offset the \$100 of nontaxable nonbusiness dividend income against its \$150 of interest expense, leaving only \$50 of interest expense for P to deduct from its \$200 of business income. Thus, P's income subject to apportionment and taxation by California now rises to \$150.

As this example demonstrates, P's apportionable business income increases from \$50 to \$150 solely as a result of the receipt of \$100 of nontaxable dividend income. In other words, the result of the California interest offset is to increase P's apportionable business income by \$100,

exactly the same amount as P's dividend income that California may not constitutionally subject to taxation.<sup>8</sup> Viewed from another perspective, P's apportionable business income in this instance (\$150) is the same that it would have been if all of its \$300 of gross income had consisted of business income. P is thus afforded no benefit from its ownership of nonbusiness, nontaxable assets. This is exactly what the Court found impermissible in *National Life*.

### III. THE INTEREST OFFSET RULE DISCRIMINATES AGAINST INTERSTATE COMMERCE BY DISALLOWING A DEDUCTION TO A NON-DOMICILIARY CORPORATION SOLELY ON THE BASIS OF ITS DOMICILE.

#### A. Facial Discrimination Against Interstate Commerce Is Virtually *Per Se* Invalid.

It is also well settled that "State laws discriminating against interstate commerce on their face are 'virtually *per se* invalid.'" *Camps Newfound/Owatonna, Inc. v. Town of Harrison*, 520 U.S. 564, 575 (1997) (quoting *Fulton Corp. v. Faulkner*, 516 U.S. 325, 331 (1996) (quoting *Oregon Waste Sys., Inc. v. Department of Envtl. Quality*, 511 U.S. 93, 99 (1994))). See also *South Cent. Bell Tel. Co. v. Alabama*, 119 S. Ct. 1180, 1185 (1999) (holding invalid an Alabama franchise tax that facially discriminated against interstate commerce). As the Court observed in *Oregon Waste Systems, Inc. v. Department of Environmental Quality*:

Because the Oregon surcharge is discriminatory, the virtually *per se* rule of invalidity provides the proper legal standard here, not the *Pike* balancing

<sup>8</sup> Of course, if P's dividend income is greater than its interest expense, California will be unable to tax *all* of P's dividend income by operation of the offset rule. However, *any* taxation of that income that is not connected to the state is unconstitutional.



test. As a result, the surcharge must be invalidated unless respondents can "sho[w] that it advances a legitimate local purpose that cannot be adequately served by reasonable nondiscriminatory alternatives." Our cases require that justifications for discriminatory restrictions on commerce pass the "strictest scrutiny." The state's burden of justification is so heavy that "facial discrimination by itself may be a fatal defect."

511 U.S. 93, 100-01 (1994) (citations omitted and alteration in original).

For the reasons set forth by Hunt-Wesson in its brief, section 24344(b) facially discriminates against interstate commerce in violation of the Commerce Clause by disallowing an otherwise deductible expense to a nondomiciliary corporation, thereby increasing California taxable income based solely on the fact that the taxpayer is domiciled outside California.

#### **B. Section 24344(b) Facially Discriminates Against Interstate Commerce.**

California's interest offset rule treats local corporations more favorably than their out-of-state competitors. A local corporation obtains a deduction for all of its interest expense whether or not it has nonbusiness income, whereas a nondomiciliary corporation has its net interest expense deduction reduced by the amount of its nonbusiness income—even if the interest expense bears no relationship to that nontaxable nonbusiness income. Because disallowance of the deductions turns solely on the domicile of the corporation, *i.e.*, whether California taxes the corporation's intangible income as its state of domicile, the offset rule facially discriminates against interstate commerce and is *per se* invalid.

One would normally expect a California-domiciled corporation to have a significantly higher amount of California taxable income than an out-of-state corporation with identical items of business income, nonbusiness dividend income and interest expense. Each corporation would have the same amount of taxable business income apportioned to California. At the same time, the nonbusiness dividends received by the California-domiciled corporation would be allocated exclusively to, and taxed only by, California, while the nonbusiness dividends received by the out-of-state corporation would be constitutionally exempt from taxation in California. The interest offset rule upends this expectation in a manner that discriminates against interstate commerce.

The discrimination inherent in California's interest offset rule is illustrated by the following example:

**Example 2.** Assume that a California-domiciled corporation and an out-of-state corporation each has business income before interest expense of \$100, interest expense of \$50 and nonbusiness dividends from a nonunitary, out-of-state subsidiary in the amount of \$50. Assume that under the three-factor formula as applied by California, each corporation apportions 30% of its net business income to California.

If the interest offset rule is *not* applied, then the California taxable income of the out-of-state corporation would be \$15 ( $((\$100 \text{ business income minus } \$50 \text{ of interest expense}) \times 30\%)$ ) and the California taxable income of the California-domiciled corporation, which pays California tax on the full amount of its nonbusiness dividend income, would be \$65 ( $((\$100 \text{ business income minus } \$50) \times 30\% + \$50 \text{ of nonbusiness dividend income})$ ). Just as one would expect, the California-domiciled taxpayer has a higher



California taxable income than the out-of-state taxpayer.

Application of the interest offset rule turns this result on its head. Under the interest offset rule, the out-of-state taxpayer's interest deduction is reduced by the full amount of its nonbusiness dividend income. At the same time, the California corporation continues to be permitted to deduct the full amount of its interest expense. Under the interest offset rule, however, its interest deduction is taken against its nonbusiness income allocable entirely to California, rather than against its apportionable business income. Thus, the out-of-state corporation and the California corporation, which one would expect to have a higher California taxable income, each have the *same* taxable income—\$30 (\$100 of business income  $\times$  30%). This is true even though the in-state corporation's nonbusiness dividends are taxable entirely by California and the out-of-state corporation's nonbusiness dividends are constitutionally exempt from California tax.

As this example demonstrates, the interest offset rule penalizes one corporation while at the same time providing a significant advantage to the other.<sup>9</sup> The sole basis for this disparate treatment is the corporation's state of domicile. A corporation domiciled in California has its tax burdens lessened while an out-of-state corporation bears a proportionally greater tax burden by operation of the

<sup>9</sup> An alternative means of characterizing this result is that the interest offset rule effectively causes the nonbusiness dividends to be treated as if they were taxable business income. Thus, the out-of-state corporation in effect is required to apportion 30 percent (i.e., \$15) of its nonbusiness, nontaxable dividends to California, and the in-state corporation is permitted to apportion 70 percent (i.e., \$35) of its nonbusiness dividends *outside* California, even though those dividends, under California's rules, should be assigned entirely to California.

interest offset rule. The concept that money is fungible does not justify this result. Money is equally fungible for both corporations. This is a straightforward case of facial discrimination against interstate commerce and, under the Court's precedents, is *per se* invalid.

In sum, by applying the interest offset rule, domiciled taxpayers receive an advantage over nondomiciled taxpayers. Nondomiciled taxpayers effectively are taxed on their nonbusiness dividend income, which is constitutionally protected from taxation by California. As demonstrated by the examples above, the interest offset rule—which wholly fails to match interest expense to the income to which it is attributable—is an unconstitutional attempt to tax income that California is prohibited from taxing.

### CONCLUSION

The judgment of the Court of Appeal of California for the First Appellate Division should be reversed.

Respectfully submitted,

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General Electric Company*

November 12, 1999

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## **APPENDIX**

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APPENDIX

[STATE LOGO]

STATE OF CALIFORNIA  
FRANCHISE TAX BOARD  
PO Box 1286  
Rancho Cordova CA 95741-1286

December 23, 1997

In Reply refer to  
392:HW:PC  
Mail Stop D-12

Mr. Frank A. Yanover  
General Electric Company  
12 Corporate Woods Blvd., 3rd Floor  
Albany, NY 12211

Re: Protest of Notices of Proposed Assessments  
Corporation Number: 0000251  
Income Years Ended: 12/84 through 12/86

Dear Mr. Yanover,

In our meeting on December 8, 1997, you indicated that General Electric Company disagreed with the interest offset adjustment, and the June 6, 1997 *Hunt-Wesson* case was mentioned.

As you no doubt are aware, Superior Court decisions such as *Hunt-Wesson* are not citable as precedent. Thus, the Franchise Tax Board is required to enforce a statute unless there is a final court of appeal decision holding the statute unconstitutional. Depending on the outcome of the pending litigation of the *Hunt-Wesson* case, an alternate method may be used to assign interest expense to non-business income. This method is referred to as the asset allocation method. Should the interest offset adjustment be held to be unconstitutional and should the taxpayer appeal the interest offset based on the *Hunt-Wesson* case, the asset allocation method may be used to determine the interest expense allowable.



Authority for the asset allocation method is found in R&TC § 25120 and 18 CCR § 25120(d). 18 CCR § 25120(d) provides for the proration of deductions between business and nonbusiness income where expenses related to both classes of income and the proration method fairly distributes the expense. The basis for an asset allocation method to prorate expenses is that money is fungible and is attributable to all activities of the taxpayer. The asset allocation must be computed on a combined basis which is consistent with the California Supreme Court decision in *Pacific Telephone and Telegraph v. FTB*, 7 Cal. 3d 544. The asset allocation method generally follows the rules set forth in 18 CCR § 24344(c)—the water's edge foreign investment interest offset. The water's-edge interest offset is based on the federal asset allocation method in IRC § 864(e) and federal regulations at § 1.861-9T, with one key exemption. The water's-edge provisions contain special rules for interest on debt deposited in restricted accounts. Use of restricted accounts allows for some additional direct tracing that is not provided for in the federal regulation. The restricted account concept for the assignment of interest expense to nonbusiness dividends will not be used outside the scope of the water's-edge interest offset provisions.

The specific process for applying the asset allocation method is as follows:

- (1) Determine the amount of total interest expense. Total interest expense is the sum of all interest expense for all members of the combined report, less intercompany interest expense.
- (2) Determine any interest from qualified nonrecourse debt. The interest from qualified nonrecourse debt is directly assigned to the asset acquired with the debt, and is considered business or nonbusiness depending on the char-

acter of the related asset. Both the asset and the interest expense are excluded from the asset allocation method.

(3) Determine the asset pool. Assets are valued at average federal tax basis net of depreciation and contra asset accounts (such as bad debt reserves), less intercompany accounts and assets associated with qualified nonrecourse debt. Stock basis in subsidiaries owned more than 50% but not combined is increased by the subsidiaries' earnings and profits for the period in which the stock was held by more than 50%.

(4) Compute the ratio of nonbusiness assets to total assets. Nonbusiness assets includes all nonbusiness assets on the balance sheet (other than those associated with qualified nonrecourse debt), not just those assets paying nonbusiness interest and dividends for the current year.

(5) Determine interest expense assigned to nonbusiness income. The ratio computed in (4) is multiplied by total interest expense determined in (1), less specifically assigned interest expense determined in (2), to determine the amount of interest expense assigned to nonbusiness income.

The amount of interest expense assigned to nonbusiness income using the asset allocation method may not exceed the amount of the § 24344(b) interest offset.

To reiterate, the asset allocation method is an alternate basis for adjustment in the event the interest offset provision of R&TC § 24344(b) is deemed unconstitutional in future litigation. Any information you provide for the asset allocation method will not affect the existing interest offset adjustment.

As we discussed, please provide your computation of interest expense attributable to nonbusiness income using

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the method described above. In addition, please provide the supporting schedules for your computation. Since certain business/nonbusiness income adjustments are still being disputed, please provide a computation for the following scenarios:

1. The gains on [name redacted] and the [name redacted] division are business income.
2. The gains on [name redacted] and the [name redacted] division are nonbusiness income.
3. The gain on [name redacted] is business income and the gain on the [name redacted] division is nonbusiness income.
4. The gain on [name redacted] in nonbusiness income and the gain on the [name redacted] division is business income.

Please provide a response within sixty days. However, if additional time is required, please feel free to call me at the number listed below. To ensure proper handling, attach a copy of page one of this letter to your reply and send to the address shown above or the facsimile number shown below.

Thank you for your cooperation.

/s/ Penny Celiz  
PENNY CELIZ, Hearing Officer  
Telephone: (916) 845-6964  
Facsimile: (916) 843-2166